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**FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY**

January 5, 2001

Ms. Magalie Roman Salas
Federal Communications Commission
445 12th Street, SW
Room TW-A325
Washington, DC 20554

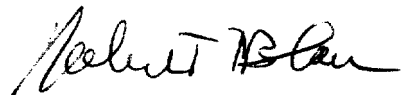
Re: Ex Parte in CC Docket Nos. 99-68

Dear Ms. Salas:

This is to give notice that I met with Deena Shetler, Legal Advisor to Commissioner Gloria Tristani, on January 4, 2001. The ex parte submitted to your office on December 22, 2000 was discussed. Also discussed in detail were the following two attachments: 1) Table 1, titled "Potential Cost of Reciprocal Compensation for Terminating Internet Traffic; and 2) "Wall Street's View of Reciprocal Compensation: A Case Study in the Law of Unintended Consequences."

In accordance with Section 1.1206(b)(1), I am filing two copies of this notice in the docket identified above. If you or your staff has any questions about any of the data referenced above, please do not hesitate to call me.

Sincerely,



Robert T. Blau
Vice President
Executive and Federal Regulatory Affairs

File Docketed 071
1/10/01

Attachments

cc: Deena Shetler

Potential Cost of Reciprocal Compensation for Terminating Internet Traffic

| Residential Internet Usage Forecasts | 1999 | 2000 | 2001 | 2002 | 2003 | Avg Ann Growth |
|---|------------------------|------------------------|------------------------|--------------------------|--------------------------|-----------------------|
| Total US Households (000s) | 103,900 | 105,000 | 106,400 | 107,700 | 109,000 | 1.25% |
| U S Online Households (000s) | 43,600 | 47,300 | 51,400 | 56,900 | 62,500 | 9.73% |
| % Penetration | 42% | 45% | 48% | 53% | 57% | |
| Avg Minutes of Access Per On-Line HH Per Day | 63 | 82 | 106 | 138 | 179 | 30.00% |
| Avg Minutes of Access Per On-Line HH Per Year | 22,888 | 29,754 | 38,681 | 50,285 | 65,370 | |
| Total Internet Access Minutes -- Residential | 997,916,800,000 | 1,407,383,120,000 | 1,988,189,008,000 | 2,861,212,858,400 | 4,085,651,050,000 | 42.65% |
| % Broadband (xDSL, Cable modems, wireless) | 4% | 12% | 20% | 29% | 36% | |
| % Dial Up | 96% | 88% | 80% | 71% | 64% | |
| Dial Up Access Minutes | 958,000,128,000 | 1,238,497,145,600 | 1,590,551,206,400 | 2,031,461,129,464 | 2,614,816,672,000 | 28.29% |
| % of Dial Up Internet Access Minutes That CLECs Terminate | 40.0% | 50.0% | 57.0% | 66.7% | 66.7% | |
| Dial Up Internet Access Minutes Terminated by CLECs | 383,200,051,200 | 619,248,572,800 | 906,614,187,648 | 1,354,306,065,335 | 1,744,082,720,224 | 41.22% |

ILEC Reciprocal Compensation Liability Scenarios -- With a Constant Recip Comp Rate of \$.004/Min.

Scenario 1: Cap That Produces Contant Recip Comp Payments

Cap on Terminating to Originating Minutes
Dial-Minutes that Qualify for Recip Comp Payments
Total Recip Comp Payments

| | 12:1 | 8:1 | 4:1 |
|------------------------|------------------------|------------------------|------------------------|
| 619,248,572,800 | 604,409,458,432 | 601,913,806,816 | 387,573,937,828 |
| \$2,476,994,291 | \$2,417,637,834 | \$2,407,655,227 | \$1,550,295,751 |

Scenario 2

Cap on Terminating to Originating Minutes
Dial-Minutes that Qualify for Recip Comp Payments
Total Recip Comp Payments

| | 6:1 | 4:1 | 2:1 |
|------------------------|------------------------|------------------------|------------------------|
| 619,248,572,800 | 302,204,729,216 | 300,956,903,408 | 193,786,968,914 |
| \$2,476,994,291 | \$1,208,818,917 | \$1,203,827,614 | \$775,147,876 |

Scenario 3

Cap on Terminating to Originating Minutes
Dial-Minutes that Qualify for Recip Comp Payments
Total Recip Comp Payments

| | 5:1 | 3:1 | 2:1 |
|------------------------|------------------------|------------------------|------------------------|
| 619,248,572,800 | 251,837,274,347 | 225,717,677,556 | 193,786,968,914 |
| \$2,476,994,291 | \$1,007,349,097 | \$902,870,710 | \$775,147,876 |

Scenario 4

Cap on Terminating to Originating Minutes
Dial-Minutes that Qualify for Recip Comp Payments
Total Recip Comp Payments

| | 4:1 | 2:1 | Bill & Keep |
|------------------------|------------------------|------------------------|------------------------|
| 619,248,572,800 | 201,469,819,477 | 150,478,451,704 | 0 |
| \$2,476,994,291 | \$805,879,278 | \$601,913,807 | \$0 |

Scenario 5

Cap on Terminating to Originating Minutes
Dial-Minutes that Qualify for Recip Comp Payments
Total Recip Comp Payments

| | 3:1 | Bill & Keep | Bill & Keep |
|------------------------|------------------------|------------------------|------------------------|
| 619,248,572,800 | 151,102,364,608 | 0 | 0 |
| \$2,476,994,291 | \$604,409,458 | \$0 | \$0 |

Sources:

Total US Households (000s)
U S Online Households (000s)
Avg Minutes of Access Per On-Line HH Per Year
% Broadband (xDSL, Cable modems, wireless)
% of Dial Up Internet Access Minutes That CLECs Terminate

Sanford Bernstein & Co and McKinsey & Co., *Broadband!*, Jan. 2000
Sanford Bernstein & Co and McKinsey & Co., *Broadband!*, Jan. 2000
Nielsen 9/14/00 Press Release; Cahners 3/28/00 Press Release; Thomas Weisel Partners, *Media Metrix's July Internet Usage Trends*, 8/23/00
Dean Witter Morgan Stanley, *The Broadband Report Reaping What You Sow: ROI in the Broadband Market*, May 2000
ALTS Press Release

For Comparable Forecasts See Also:

U S Online Households (000s)
% Broadband (xDSL, Cable modems, wireless)

Dean Witter Morgan Stanley, *The Broadband Report Reaping What You Sow: ROI in the Broadband Market*, May 2000
Hoak Breedlove Wesneski & Co., *The Last Race for the First Mile*, 8/2/00

Wall Street's View of Reciprocal Compensation: A Case Study in the Law of Unintended Consequences

The recent debate over reciprocal compensation has largely been couched as a fight between the CLECs and the ILECs. Closer examination of Wall Street's view of the issue indicates, however, that the FCC's failure to resolve the matter has raised the cost of capital for all CLECs – especially facilities based carriers -- at a time when access to capital is becoming increasingly difficult and critical.

- Most CLECs are not widely followed by Wall Street analysts due to their size. Investors often will not take the time to determine whether individual CLECs have built business plans around questionable sources of revenues such as reciprocal compensation. Thus, when carriers like ICG Communications or Intermedia restate earnings based on these revenues not materializing, other CLECs – including those that do not depend on reciprocal compensation -- invariably get tarred with the same brush.
- During the recent debate over legislation that would have eliminated reciprocal compensation for dial up Internet access traffic, several CLECs launched a radio and newspaper ad campaign designed to pressure Congress to avoid enacting legislation. This was done by claiming that the loss of recip comp payments would somehow cause dial up Internet access rates to go up by as much as 30 percent. However specious such claims might be as a factual matter, the CLECs' ads may have caused investors to question whether the possible use of reciprocal compensation to subsidize dial-up Internet access prices will limit future earnings of higher priced DSL as well as cable modem service – neither of which qualify for recip comp payments. If so, these same concerns may have contributed to the recent demise of DLEC stock prices which are currently selling 90% below their 52 week highs.

According to a recent Merrill Lynch report, most CLECs have resisted the temptation to game Sec. 251(b)(5) of the Telecom Act by trying to collect reciprocal compensation for terminating one-way dial up Internet access traffic.

Reciprocal Compensation as a % of Revenue

| Companies Under Coverage | 3Q99 | 4Q99 | 1Q00 | 2Q00 | Companies Under Coverage | 3Q99 | 4Q99 | 1Q00 | 2Q00 |
|--------------------------|------|------|------|------|--------------------------|------|------|------|------|
| Adelphia | 20% | 23% | 15% | 10% | Rhythms | 0 | 0 | 0 | 0 |
| Allegiance | 0 | 0 | 0 | 0 | Teligent | 0 | 0 | 0 | 0 |
| AT&T Canada | 0 | 0 | 0 | 0 | US LEC | 62 | 74 | 12 | 12 |
| Covad | 0 | 0 | 0 | 0 | Winstar | 1 | 5 | 5 | 3 |
| GT Group Telecom | 0 | 0 | 0 | 0 | XO | 4 | 5 | 4 | 4 |
| Intermedia | 9 | 1 | 12 | 3 | e.spire | 18 | 18 | 24 | 21 |
| McLeodUSA | 0 | 0 | 0 | 0 | Electric Lightwave | 21 | 18 | 17 | 17 |
| Mpower | 0 | 0 | 0 | 0 | Focal | 53 | 41 | 41 | 35 |
| Network Plus | 0 | 0 | 0 | 0 | ICG | 21% | 20% | 23% | 18% |
| NorhtPoint | 0 | 0 | 0 | 0 | | | | | |

Source: K. Hoexter, *Broadband Barometer*, Merrill Lynch, 9 October 2000, p. 11.

Even though many-facilities based CLECs, like RCN, have avoided gaming reciprocal compensation provision in the Telecom Act, they are still being penalized. Rather than spend the time and resources required to differentiate individual carriers based on their reliance on questionable revenue sources like reciprocal compensation, many investors, including institutional investors, simply avoid CLEC stocks all together.

- “We believe RCN is significantly undervalued and is being unfairly grouped with other CLECs. Even though the difficult issues [like reciprocal compensation] other CLECs face have little impact on RCN.... RCN has almost no reciprocal compensation, and switched access and long distance revenues counts for a small percentage of total revenue.” M.J. Recarey, CFA, *RCN Corporation*, Fahnstock & Co., 13 Oct. 2000, p.1.
- “In the near term, we believe the only way for CLECs to regain investor confidence is through simple “blocking and tackling” – strong revenue and access line growth, continued margin improvement, and sustained ARPU. ***In addition, we hope to see migration away from dubious revenue streams such as reciprocal compensation and switched access*** and toward more valuable long-term sources of revenue, including local voice and (increasingly) high-speed and enhanced data services.” C. Carr, *Telecom Services: CLECs*, CIBC World Markets, 2 Oct. 2000, p.2-3

Investors and securities analysts that do differentiate CLECs clearly favor those that are not relying on or at the very least moving to immediately reduce their dependence on reciprocal compensation revenues.

- “We are downgrading US LEC to Neutral from Buy.... **We believe US LEC is simply a company with zero visibility in evolving to a real business from a pure recip comp play.**” J. Grubman, *CLECs: Clean Up of Ratings, Price Targets & DCFs*, Salomon Smith Barney, 17 Oct. 2000, p. 2.

Finally, the debate over reciprocal compensation is not just about the transfer of revenue and shareholder value between carriers. The FCC also bears some fiduciary responsibility to investors to eliminate regulatory arbitrages like reciprocal compensation that carriers can and have used – usually through “creative” accounting – to artificially inflate revenues, earnings, and stock prices. While such practices may be understandable for start up carriers, those same practices can subject investors to grave risk if not divulged or even well understood.

- “We have long held the view that when any given arbitrage opportunity in the telecommunications service space comes to an end, the result is never good for the company who benefited from its exploitation. In the case of WorldCom, separating reciprocal compensation gains from the standard income statement does have the benefit of making the revenue growth more robust.... Our traditional problem with such an issue is that with growth companies, such as WorldCom, it becomes more difficult to more than compensate for such growth in the following year, as the arbitrage evaporates, as the company has suggested it will. **The official comment [from WorldCom] that reciprocal compensation is ‘...an artificial payment ... that is going to zero’ is incredibly telling from one of the one of the industry’s leading management teams.** As we had pointed out, ... those companies most reliant upon such arbitrage opportunities are destined to see [this] source of revenue and funding disappear almost over night.” G. Miller, *WCOM: Less than Expected Quarter*, ING Barings, 27 Oct. 2000, p. 4.